

CSX OIL AND GAS CORP.

G. J. MORGAN

IBLA 87-164

Decided September 9, 1988

Appeals from a decision of the Colorado State Office, Bureau of Land Management, upholding a prior decision which found that drainage had occurred from lands within oil and gas lease C-22214A and assessed compensatory royalties.

Vacated and remanded.

1. Oil and Gas Leases: Compensatory Royalty--Oil and Gas Leases:
Drainage

Compensatory royalties for failure to protect against drainage commence upon passage of a reasonable time following notice to the lessee that drainage is occurring. Such notice may be given by BLM or by a third party. If BLM can show that a lessee knew or a reasonably prudent operator would have known that drainage was occurring, the requirement of notice is satisfied.

APPEARANCES: Laura L. Payne, Esq., Denver, Colorado, for CSX Oil and Gas Corporation; G. J. Morgan, pro se; Mary Katherine Ishee, Esq., William R. Murray, Esq., Office of the Solicitor, Washington, D.C., and Lyle K. Rising, Esq., Office of the Regional Solicitor, Denver, Colorado, for the Bureau of Land Management.

OPINION BY ADMINISTRATIVE JUDGE MULLEN

CSX Oil and Gas Corporation (CSX) and G. J. Morgan appeal from a decision of the Colorado State Director, Bureau of Land Management (BLM), dated December 8, 1986, upholding a prior decision which found that drainage had occurred from lands within oil and gas lease C-22214A and assessed compensatory royalties. Appellants each held a 50-percent record title interest in lease C-22214A when this lease expired some 14 months prior to the State Director's decision.

BLM found that lands within lease C-22214A, specifically, the S\ SW^ NW^ sec. 13, T. 8 N., R. 93 W., sixth principal meridian, Moffat County, Colorado, had been drained by the Damson Oil North Lay Creek well in the NW^ SE^ sec. 13. Drainage was found to have occurred between April 1, 1976, and September 30, 1985, the date of lease expiration.

After conducting a technical and procedural review of a decision of the Deputy State Director for Minerals, dated November 5, 1986, the Colorado State Director found that substantial drainage had occurred from the Almond Sand formation lying under the lands formerly leased to appellants. This finding was based upon his determination that 0.70 percent of production of the Damson well came from lands which had been subject to lease C-22214A. ^{1/} Using the production and cost figures generated by CSX, the State Director also found that an economic protective well could have been drilled.

^{1/} This figure, referred to as the drainage factor, represents a change from the Nov. 5 decision which held that the drainage factor was 4.675 percent.

Oil and gas lease C-22214A was issued noncompetitively to Howell Spear effective October 1, 1975. At the time of lease issuance, the nearby Damson well was already producing gas. That well was completed in March 1969 and obtained first production in June 1972. Lease C-22214A was assigned to CSX 2/ in November 1975. By decision of March 19, 1982, a portion of the land in lease C-22214A was designated as being within an undefined addition to an undefined known geologic structure (KGS). Appellant Morgan held a 50-percent interest in lease C-22214A from February 1984 to September 30, 1985.

CSX contends that the State Director erred in assessing compensatory royalty because BLM failed to notify lessees during the life of the lease that BLM believed drainage was occurring. It argues that such notice is a prerequisite to BLM's requiring an offset well or assessing compensatory royalty. In support of its position, CSX quotes from this Board's decision in Nola Grace Ptasynski, 63 IBLA 240, 89 I.D. 208 (1982):

The obligation to protect a leasehold from drainage arises not upon completion of the draining well, but only after the passage of a reasonable time subsequent to notification by the lessor that an adjoining well is draining the leasehold. See U.V. Industries v. Danielson, [602 P.2d] at 585. Thus, had appellant herein proceeded to complete an offset well within a reasonable time after notice, there would have been no assessment for intervening drainage. If compensatory royalty is designed to compensate the lessor for drainage occurring because of a failure to complete a protective well, it is difficult to understand why the lessor should be compensated for the period of time during which the lessee was under no obligation to drill, viz., from completion of the offending well to a reasonable time after notification. [Emphasis added; footnote omitted.]

2/ Appellant CSX was known as Texas Gas Exploration Company at the time of assignment.

63 IBLA at 256-57, 89 I.D. at 217-18. The first notice from BLM that lease C-22214A was subject to drainage was received on June 9, 1986, some 8 months after lease expiration. CSX argues that when notice was given it was no longer the Government's lessee, and the Government cannot assess compensatory royalty after the expiration date. CSX contends that BLM's issuance of noncompetitive lease C-22214A, some 6 years after completion of the Damson well, and BLM's subsequent acceptance of rentals substantiate a reasonable belief that no drainage was occurring.

In the alternative, CSX contends that if the BLM notice that drainage was occurring had been tendered in a timely manner, CSX would not have been required to either drill an offset well or pay compensatory royalty because of the prudent operator rule. That rule, which Ptasynski describes as a limitation on a lessee's implied obligation to protect against drainage, states that "there is no obligation upon the lessee to drill offset wells unless there is a sufficient quantity of oil or gas to pay a reasonable profit to the lessee over and above the cost of drilling and operating the well." Olsen v. Sinclair Oil & Gas Co., 212 F. Supp. 332, 333 (D. Wyo. 1963). CSX calculates that it would have incurred a \$158,026 loss had it drilled a protective well. Finally, CSX states that all production from the Damson well can be attributed to the 320-acre spacing unit on which that well is located, no part of which is within C-22214A.

Appellant Morgan objects to the decision on appeal because BLM has assessed him for 9\ years of compensatory royalty despite the fact that he held a 50-percent interest in lease C-22214A for only 20 months. He

contends that the decision disproportionately impacts him and ignores the fact that "the federal lands from which drainage allegedly occurred were covered by at least two different Federal leases in the period from 1972 to 1985, and record title to said Federal leases was held by at least seven separate individuals or entities during the period." ^{3/} Morgan complains that only he and CSX have been assessed for drainage from lease C-22214A.

Appellant Morgan also contends that BLM has the burden of proving that an economic well could have been drilled, and BLM wrongly placed the burden of proof in this area on the appellants. Morgan joins with CSX in reciting that Ptasynski requires notification from BLM before the duty to protect against drainage arises. Morgan notes that by giving notice of substantial drainage from the leased lands after the lease expired, BLM has deprived him of any ability to perform his contractual duties by drilling an offset well. He contends that BLM could have known of potential drainage as early as 1972 and did in fact know of such potential drainage in March 1982 when designating part of C-22214A as within a KGS. He similarly agrees with CSX that no drainage has in fact occurred from lease C-22214A, citing the drilling and spacing orders of the Colorado Oil and Gas Commission. Morgan contends that BLM's assessment of royalty for drainage commencing in April 1976 is barred by the applicable Colorado statutes of limitation.

In response, BLM defends the State Director's decision, arguing that the Board erred in Ptasynski when holding that a lessee's obligation to

^{3/} Our review of case file C-22214A reveals that record title was in the names of six different entities between November 1975 and the date of expiration.

protect a leasehold from drainage arises only after a reasonable time subsequent to notification by the lessor that an adjoining well is draining the leasehold. BLM contends that numerous courts and authorities have held that notice to the lessee of drainage is not ordinarily a prerequisite to a lessor's recovery of compensatory damages. BLM advances its position that in Ptasynski the Board's reliance on U.V. Industries v. Danielson, 184 Mont. 203, 602 P.2d 571 (Mont. 1979), was misplaced. BLM notes that U.V. Industries was a damages action, but all of the cases cited by the Montana Supreme Court as its basis for requiring notice in a damages action were cases involving forfeiture. BLM explains that a judicial declaration of forfeiture is an equitable decree that is regarded as a harsh and extraordinary remedy. Before a court will declare a forfeiture based on a lessee's failure to satisfy the implied covenant to protect against drainage, the lessor must notify the lessee, indicate that the breach was substantial, and allow a reasonable period for the lessee to drill, BLM states. Only after these events had occurred and the lessee still refused to drill, BLM notes, would a court terminate the lease contract by judicial decree. ^{4/} BLM maintains its position that no such procedures are applicable in the present case.

^{4/} In support of this position, BLM cites 4 H.R. Williams, Oil and Gas Law | 682 (1985), wherein it is stated: "The reason for requiring that notice and demand precede a suit for cancellation of the lease for breach of covenant is easy enough to discover. Whether the action be considered as one for extraordinary relief in equity or as one to enforce a right of entry for breach of a condition subsequent, forfeiture is the relief sought and accordingly the action is cognizable in equity. Since equity dislikes forfeiture and since one seeking equity must do equity, notice, demand and an opportunity to cure the breach are required."

In addition to the implied covenant to protect against drainage, BLM observes that express lease provisions and applicable regulations require the lessee to protect against drainage. According to BLM, these lease terms and regulations place the burden of protection, and indirectly the initial burden of drainage detection, on the lessee. It is BLM's position that the specific lease terms and Department regulations are consistent with the theory of implied covenant, which recognizes certain implicit duties owed by a lessee by virtue of his holding operating rights to the lease. BLM acknowledges that it did not detect drainage from lease C-22214A until after the lease expired, but charges that CSX was long aware of the offending Damson well and had even sought to purchase it. BLM contends that it is not required to detect drainage and, therefore, its issuance of lease C-22214A noncompetitively and its subsequent acceptance of rental should not preclude it from recovering compensatory royalties.

The lease provision that BLM refers to is section 2(c)(1) of the standard noncompetitive oil and gas lease (Form 3110-2 (Sept. 1973)). This section states:

Sec. 2. The lessee agrees:

* * * * *

(c) Wells. -- (1) To drill and produce all wells necessary to protect the leased land from drainage by wells on lands not the property of the lessor, or lands of the United States leased at a lower royalty rate, or as to which the royalties and rentals are paid into different funds than are those of this lease; or in lieu of any part of such drilling and production, with the consent of the Director of the Geological Survey, to compensate the lessor in full each month for the estimated loss of royalty through drainage in the amount determined by said Director.

Applicable regulations are 43 CFR 3100.3-2 (1982), 5/ which virtually replicates the lease provision quoted above, and 30 CFR 221.21(c) (1982), 6/ which states:

(c) The lessee shall drill diligently and produce continuously from such wells as are necessary to protect the lessor from loss of royalty by reason of drainage, or, in lieu thereof, with the consent of the supervisor, he must pay a sum estimated to reimburse the lessor for such loss of royalty, the sum to be computed monthly by the supervisor.

In Ptasynski, the Board held that the prudent operator rule was not extinguished by the express obligations imposed upon a Federal lessee by 30 CFR 221.21(c). The Board also held, relying on U.V. Industries v. Danielson, that royalties lost by a lessee's failure to drill an offset well do not commence on completion of the offending well, but upon the lessee's failure to drill a protective offset well within a reasonable time after notice.

BLM correctly points out that the Supreme Court of Montana relied on lease forfeiture cases when holding in U.V. Industries that notice was a prerequisite to an action for damages. However, BLM also points out the past practice of the Department to give such notice and the past policy to discourage collection of compensatory royalties for drainage which had

5/ This regulation was in effect from June 13, 1970, to Aug. 22, 1983, when it was changed slightly and renumbered as 43 CFR 3100.2-2. 48 FR 33662 (July 22, 1983); 35 FR 9670 (June 13, 1970). Minor changes have since occurred. 53 FR 17351 (May 16, 1988).

6/ This regulation was replaced by 30 CFR 221.22 on Nov. 26, 1982. 47 FR 47769. On Aug. 12, 1983, 30 CFR 221.22 was redesignated as 43 CFR 3162.2. 48 FR 36583. Minor changes have since occurred. 53 FR 17351 (May 16, 1988).

occurred prior to such notice. We believe that a notice requirement is consistent with the prudent operator rule and with longstanding Departmental practice. We, therefore, decline to adopt the position urged upon us by BLM that no notice is necessary. Though we so conclude, we must also acknowledge the need to clarify Ptasynski to permit recovery of compensatory royalty if BLM can show that a lessee knew or a reasonably prudent operator would have known that drainage was occurring, regardless of BLM's failure to give formal notice of that occurrence.

In testing a lessee's performance of an implied covenant, such as the covenant to protect against drainage, the great majority of oil and gas producing jurisdictions apply the prudent operator standard. 5 Williams and Meyers, Oil and Gas Law | 806.3 (1986). This standard is described by Judge Van Devanter in Brewster v. Lanyon Zinc Co., 140 F. 801 (8th Cir. 1905), as one calling for the exercise of reasonable diligence: "Whatever, in the circumstances, would be reasonably expected of operators of ordinary prudence, having regard to the interests of both lessor and lessee, is what is required." Id. at 814. The prudent operator standard is distinguishable from an absolute standard, whereby a lessee is liable without fault for nonperformance of an implied covenant, and it is also distinguishable from a standard based on a lessee's subjective good faith. Williams and Meyers, supra at | 806.

If we were to adopt the position urged by BLM and hold that notice of drainage is immaterial to an action for compensatory royalty, our holding would effectively erode the prudent operator standard and replace that

standard with an absolute standard requiring an operator to warrant against any loss as a result of drainage. We expressly decline to do so.

Moreover, at least since 1932 the Department has provided a lessee with notice of drainage and has discouraged collection of compensatory royalties prior to such notice. ^{7/} In a letter dated August 25, 1932, to the Director, Geological Survey, Acting Secretary Dixon wrote:

It has always been the practice of the Department in land and mining cases, where certain acts are required to be done or payments to be made to serve notice upon the parties in interest of the requirements, or allow them to show cause why certain action should not be taken. A similar practice should be followed in these cases of oil and gas leases; when the Department ascertains that offset wells are necessary the parties should be advised in writing that they must drill the necessary offsets diligently, or in lieu thereof pay compensatory royalty to the Government.

Hereafter in all such cases written notice should be given to the lessees and other parties in interest of the Department's requirements. In all pending cases, where such notice was not given in the past, the demand for "back royalties" should be dropped. [Emphasis in original.]

This practice was likely changed, BLM states, as a result of the dramatic increase in oil and gas activity during the 1970's, when the resources and personnel of Geological Survey were stretched to accommodate new volumes. ^{8/}

BLM also acknowledges that it continues to provide a lessee with notice of drainage when it identifies such drainage within 1 year of completion of _____
^{7/} See BLM Answer brief at page 30, filed May 6, 1987, in IBLA 86-1572, an appeal by Chevron USA, Inc., involving Tribal lease No. 0258-2193. BLM has specifically incorporated by reference pages 12-35 of this pleading in its Answer.
^{8/} Id. at 31 n.7.

the offending well. BLM Manual 3160-2.11C provides that the authorized officer will notify a lessee by certified mail that a potential drainage situation exists and will request that the lessee submit plans within 60 days for protecting the lease. If compensatory royalty is thereafter assessed, it will be due from the day next following expiration of the reasonable period of time stated in the notice. 9/ Id.

BLM's action in the instant case appears to be contrary to a longstanding Departmental policy in favor of granting notice to a lessee. This fact and the well-established principle requiring that a lessee act prudently in protecting the leasehold from drainage are the basis for our holding here. If BLM seeks to recover compensatory royalty without the need for notice, it may effect such change by rulemaking. Bruce Anderson, 80 IBLA 286, 301 n.7 (1984).

[1] Our review of Ptasynski prompts us to clarify that case in one regard. If BLM has not notified a lessee of drainage, but can prove that such lessee knew or that a reasonably prudent operator would have known that drainage was occurring, BLM may recover compensatory royalties. In such instance, the compensatory royalties would begin to accrue after the passage of a reasonable time following the date of the lessee's knowledge. This clarification is consistent with a prudent operator's duty to exercise reasonable care and diligence in protecting the lessor against drainage.

9/ This policy applies to "current drainage cases," i.e., those in which BLM has identified drainage within 1 year of completion of the offending well. A distinct policy is applied to "older drainage cases." See BLM Drainage Protection Handbook at H-3160-2 IIB.

U.V. Industries v. Danielson, 602 P.2d at 578. ^{10/} If formal notice is given by BLM, that notice is a basis for a subsequent assessment of compensatory royalties. However, if BLM is to assess compensatory royalties for any period prior to the time it gives formal notice, the burden of proving that a lessee knew or that a reasonably prudent operator would have known of drainage rests with BLM. See Lafitte Co. v. United Fuel Gas Co., 177 F. Supp. 52, 59 (E.D. Ky. 1959). Our clarification of Ptasynski in this respect allows BLM to assess compensatory royalties if BLM is able to prove that a lessee actually knew or a reasonably prudent operator would have known that drainage was occurring.

BLM never gave appellants notice of drainage during the life of lease C-22214A and has not attempted to prove that appellants knew or that a reasonably prudent operator would have known of such drainage. Therefore, the State Director's decision must be vacated. If, upon remand, BLM should issue a decision assessing compensatory royalties, that decision should set forth the facts necessary to demonstrate appellant's knowledge of drainage. The decision should also set forth the legal basis for assessing appellant Morgan for drainage during periods when he was a stranger to the lease and the legal basis for not joining all parties who held an interest in the

^{10/} "Whatever is notice enough to excite attention and put the party on his guard and call for inquiry, is notice of everything to which such inquiry might have led. When a person has sufficient information to lead him to a fact he shall be deemed conversant of it." Wood v. Carpenter, 101 U.S. 135 (1879), quoting from Kennedy v. Green, 3 Myl. & K. 722. "It will not do to remain willfully ignorant of a thing readily ascertainable." Williams v. Woodruff, 35 Colo. 28, 85 P. 90, 95 (1905), quoting from McQuiddy v. Ware, 87 U.S. (20 Wall.) 14, 22 L.Ed. 311 (1874).

See also Comments to Article 136, Title 31, Louisiana Revised Statutes (1980).

lease during the period that drainage was occurring. Any such decision should also set forth the legal basis for assessing compensatory royalty for periods that appear to be beyond the reach of applicable statutes of limitations. Indian Territory Illuminating Oil Co. v. Rosamond, 190 Okla. 46, 120 P.2d 349 (1941). 11/

Therefore, pursuant to the authority delegated to the Board of Land Appeals by the Secretary of the Interior, 43 CFR 4.1, the decision of the Colorado State Director is vacated and remanded.

R. W. Mullen
Administrative Judge

I concur:

Franklin D. Arness
Administrative Judge

11/ We do not reach the question of whether an offset well is commercially practical. If it can be shown that lessees knew or that a reasonably prudent operator would have known that drainage was actually occurring, the determination that an offsetting well was commercially feasible (and the calculation of compensatory royalties due) must be based on conditions existing after the expiration of a reasonable time from the date of notice.